INTERNATIONAL CORPORATE GOVERNANCE NETWORK
Statement on the Global Financial Crisis

10 November, 2008

1. Introduction

1.1 The financial crisis proves beyond a doubt that we are living in a global age. Starting as a problem in the US, it has spread through the world and left investors in seemingly unrelated markets and instruments nursing large losses.

1.2 Corporate governance failings were not the only cause but they were significant, above all because boards failed to understand and manage risk and tolerated perverse incentives. Enhanced governance practices should therefore be integral to an overall solution aimed at restoring confidence to markets and protecting us from future crises.

1.3 This statement draws on the ICGN's international experience of exercising shareholder rights and promoting shareholder responsibility. ICGN has over 500 members in more than 40 countries and include investors responsible for $15 trillion in global assets. The breadth and expertise of ICGN members from investment, business, the professions and policy-making extends across capital markets enabling the ICGN to actively engage cross- border to positively impact the corporate governance reform agenda, particularly in the midst of this global financial crisis.

1.4 This statement lays out some thoughts about the role that corporate governance can and should play in restoring trust. Because the crisis is a collective problem with many and varied causes, it is directed to all concerned, including financial institutions and their boards, regulators and policy makers and, of course, shareholders themselves.

2. Governance in the context of the financial crisis

2.1 Some commentators have criticised shareholders for failing to hold boards to account. It is true that shareholders sometimes encouraged companies, including investment banks, to ramp up short-term returns through leverage. They were not always as close as they could have been to companies they owned.

2.2 Yet, a larger problem has been failure of regulators. They did not respond decisively when they realised that markets were mispricing risk. They allowed banks to operate with too little capital, with excessive leverage and too little attention to liquidity risk. They failed to pick up on poor risk management by boards and on poor lending practices in the mortgage market.

2.3 There will therefore need to be a regulatory response with heightened international coordination and one which encourages markets to take a longer term perspective. A leading priority should be to maximise the supporting contribution of governance. This will help avoid a knee-jerk reaction that impairs the ability of markets to innovate and allocate capital efficiently, adds unduly to the burden of red tape or is protectionist in motivation. It is vital that regulatory reform enhances corporate governance solutions and does not aggravate existing weaknesses.

2.4 Empowering shareholders is an important part of this, but they also have to be willing to make the necessary effort. The ICGN's detailed thinking on shareholder responsibility is set out in the ICGN's 'Statement of Principles on Institutional Shareholder Responsibilities' (see Appendix 1). This stresses the importance of institutional investors putting proper resources into governance and recognising their own accountability to their end-beneficiaries who are individual savers and pensioners. It is the job of institutional shareholders to preserve and add value for these beneficiaries over the long term.

3. What should happen next?

3.1 Equipping shareholders as the owners of companies

- The US debate on shareholder rights, particularly to appoint and dismiss directors should be expedited so that boards can be held to account. Weak shareholder rights limited their ability to hold boards to account, particularly in the areas of remuneration and risk management, which have been key to the development of the crisis.

- Giving shareholders a "say on pay" is an essential part of the solution, not just in the US but in other markets where this does not yet happen.

- Globally, we need a regulatory framework that ensures fair and transparent markets which inspire confidence in financial reporting.

- Financial institutions should make greater narrative disclosure about their business models and how they manage the risks inherent to those models. This will foster productive dialogue with shareholders.

- Voting arrangements must allow shareholders to exercise their votes across borders. At present the system does not function well and votes are lost. This is a severe handicap in a global market.

3.2 Shareholder responsibilities

- Institutional shareholders must recognise their responsibility to generate long term value on behalf of their beneficiaries, the savers and pensioners for whom they are ultimately working.

- Pension funds and those in a similar position of hiring fund managers should insist that fund managers put sufficient resource into governance that delivers long term value.

- Shareholders should take governance factors into account and consider the riskiness of a company's business model as part of their investment decision-making.

- Shareholders should pay attention to developments in other markets, including the credit market, where these may have an impact on their investments.

- They should recognise that they lose their voting rights when they lend stock. Where it is important to vote, the stock should be recalled.

- It will help establish a role for governance and shareholders, as well as preserve shareholder rights if institutions formally commit to the principles laid out in the ICGN's 'Statement of Principles on Institutional Shareholder Responsibilities' which addresses issues such as internal governance and oversight, transparency and accountability, expertise, conflicts of interest and engagement with companies.

4. The ICGN Agenda

4.1 The crisis has highlighted a number of issues which are relevant to shareholders and where the ICGN will seek to engage actively in the policy debate. These include:

Strengthening shareholder rights: Shareholders cannot play a useful role if their rights are limited. It is crucial that they are able to appoint and dismiss boards. Shareholders also need a disclosure framework which gives the ability to exercise their rights in an informed way. Government intervention in financial institutions should not undermine basic shareholder rights and corporate governance structures, including the requirement for fully independent directors, should be fully maintained.

Strengthening boards: We need to ensure that boards have the ability to lead with integrity, the right skill sets to oversee complex businesses and manage risk properly. Audit committees must also have a clear view of what is going on within the company and of the importance of full disclosure to the market. As owners, suitably empowered shareholders are well placed to hold boards to account on this.

Fair and transparent markets: Markets have become too opaque. The price and volume of transactions in equity and derivatives markets must be transparent and available to everybody. Transparency is preferable to restrictions on the use of particular techniques. Short selling, for example, is a legitimate investment tool, which adds to liquidity, helps price discovery and, through opening up hedging opportunities, often reduces volatility. We do not believe that short selling should be artificially restricted, but companies and shareholders should be aware when significant short positions are being created.

Accounting standards: There must be no political interference in setting accounting standards. The fair value approach has been blamed for encouraging pro-cyclicality. Investors generally support fair value that delivers a picture of what is actually happening. There are some challenges to address, but abandoning this approach would damage confidence in financial reporting. It is important to recognise that there is a difference between fair value used for reporting and fair value used to measure the need for regulatory capital Accounting standards also need to be clearer about when off-balance sheet business should be reported.

Remuneration Shareholders cannot take responsibility for the entire remuneration arrangements of financial institutions or other companies, but they can encourage boards to ensure that their policies do not encourage employees to take excessive risks. Provided they are given a right to vote on remuneration, shareholders should take responsibility for seeing that directors are incentivised in such a way that delivers on the agreed medium and long-term strategy and aligns their interests with those of shareholders. It is very important not to pay rewards for failure. Shareholders are likely to support regulation that underpins this principle, providing it is not overly prescriptive and genuinely delivers. They also believe it should be possible to claw back bonuses that have been paid on the basis of misstated performance or when they relate to transactions that subsequently incur substantial losses.

Credit rating agencies: There needs to be more competition in this market. Any regulation needs to be multilateral in approach and not set up barriers to new entrants. Credit rating agencies should not have exclusive rights to information that may be of value to all investors in their understanding of what is happening. Conversely investors should not be excessively reliant on credit ratings.

5. Conclusion

5.1 Corporate governance has an important role to play in overcoming the present crisis, restoring confidence for the future and preventing regulatory overkill that would damage the entrepreneurialism needed to secure economic growth. The global authorities should work with market participants to develop enhanced governance practices that will underpin other actions being taken to address the current problems.

5.2 Most importantly this involves securing and maintaining the rights of shareholders and developing the transparency needed for them to exercise these rights in a responsible, informed and considered way. Properly equipped, shareholders can play an important role in holding companies to account for the way the manage risk and incentivise board directors.

5.3 However shareholders must also recognise that they should use their share-ownership rights responsibly in the interest of creating long-term value for their beneficiaries. If they do not act responsibly their rights will be at risk.

6. Contact us

6.1 Comments on this statement are welcome and should be directed to Anne Simpson at execdirector@icgn.org or Kerrie Waring at Kerrie.waring@icgn.org or call + 44 207 612 7098.

6.2 We also invite ICGN members to send us their views on the global financial crisis via a 'Member Comment' page on the ICGN website www.icgn.org. This feedback will contribute towards shaping the debate on the subject at the next ICGN Event being held in Delaware, USA on the 10th December.

Appendix 1: Relevant ICGN Best Practice Guidance

Statement of Principles on Institutional Shareholder Responsibilities (2007)
The statement highlights the responsibilities of investors both in their external role as owners of equity and their internal governance responsibilities to their beneficiaries.
http://www.icgn.org/organisation/documents/src/Statement%20on%20Shareholder%20Responsibilities%202007.pdf

Securities Lending Code of Best Practice (2007)
The code clarifies the responsibilities of all parties engaged in stock lending.
http://www.icgn.org/organisation/documents/slc/SL_Best_Practice_rev_060707.pdf

Executive Remuneration Guidelines (2006)
The guidelines focus on how companies should be structuring pay for the long term, disclosing policies and seeking shareholder support.
http://www.icgn.org/organisation/documents/erc/guidelines_july2006.pdf

Global Corporate Governance Principles (2005)
The principles endorse the OECD Principles of Corporate Governance and provide guidance around issues of particular concern to the ICGN.
http://www.icgn.org/organisation/documents/cgp/revised_principles_jul2005.pdf